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rd Year

Today

Debt forgiveness is one option being considered by the World Bank to help reduce the Third World's commercial borrowings, according to a confidential memo obtained by the *American Banker.* ——2

A rash of fraudulent funds transfer attempts has placed the Federal Reserve System on alert. Bogus transactions over the Fed Wire are being attempted as often as twice a week, but so far only one attempt has resulted in a completed funds transfer. ——2

As required by law, the Bank Board will consider — but won't promise — a reduction this year in the assessments charged to thrifts for deposit insurance. ——2

ICI Mutual Insurance Co. has been created by the Investment Company Institute, the mutual fund industry's trade association. The new company will provide fidelity bond, directors' and officers' liability, and errors and omissions coverage for its 300 members. ——14

The weekly listing of financial services stocks features regional industry groups and price indexes. — 12

Shearson Lehman Mortgage Corp. is offering adjustable-rate home loans linked to the London interbank offered rate — apparently the second lender to offer Libor-tied mortgages. ——19

Executive Changes —— 15
In the News ——3

CORPORATE FINANCE

The accounting profession is battling a growing number of liability suits, as bankers seek to pass on the costs of bad loans to accountants. —3

The Bank of New York is selling roughly $1 billion of its commercial loan portfolio to facilitate the bank's hostile takeover bid for Irving Trust Co. Market analysts speculated that the bank was clearing the asset side of its balance sheet to boost some of its financial ratios. The Fed has expressed concern that the Irving acquisition might take its toll on Bank of New York's balance sheet. ——8

Integrating Irving Bank Corp.'s data system with the Bank of New York's system could cost up to $150 million over five years and sharply reduce future earnings, Irving told its shareholders. ——15

Chase Manhattan named its first electronics and foreign direct investment executive. Thomas Gallagher, a managing director, will run a new unit that will focus on lending to both the electronics industry and to U.S. subsidiaries of foreign companies. 8

Worth Repeating

The challenge [now] facing the bank is to find a way of providing stronger leadership in the debt workout process.

World Bank president Barber Conable in an internal memo. [Page 2]

An American Banker Special Report

US Banks Grab Share in Global Finance

By JOHN J. DUFFY
Second of a Series

LONDON — When ASDA-MFI, a retailing conglomerate, decided last year to spin off its furniture division in the largest management buyout in British history, one detail of the transaction set City of London tongues wagging: An American institution was leading the financing.

INVESTMENT BANKING: How Are Banks Doing?

For Chemical Bank, which was just setting up its British leveraged finance business, the $1.2 billion deal was a major coup. For the City establishment, it was something of a slap in the face.

"It was a very brave decision in the U.K. marketplace for [ASDA-MFI] to give the mandate to an American bank," said Andrew Jackson, managing director at Chemical Bank International Ltd. "The MBO [management buyout] was four or five times larger than had ever been done before, and Chemical had never led a buyout."

While U.S. banks, such as Citibank and Bankers Trust, had financed buyouts in Britain previously, awarding a newcomer the entire $850 million senior debt portion of the MFI deal was a stunner.

If the deal was a breakthrough for Chemical, it was also representative of a new aggressive attitude that major American banks are taking toward international corporate finance. At a time when profit margins in the Euromarkets have been pared to the bone, banks have discovered that advising and financing international mergers, acquisitions, and buyouts is a way of

US Banks: Page 20 ➤

COMMENT

The High Price of Mismatch Income

By SANFORD ROSE

What role do asset-liability mismatches play in the determination of bank stock prices? Does the marketplace bid down the stock valuations of mismatching institutions relative to those that are reasonably balanced? And if that is the case, does the marketplace penalize banks which are short funded (liability sensitive) more or less than it penalizes those that are long funded (asset sensitive)?

Put somewhat differently, although investors may be flinty hard on interest-rate bettors, might they not relent a tad when the bets produce handsome profits, as liability-sensitive positions recently have? Does not, in fact, the average investor behave like a coach extending a forgiving hand to a player whose disregard of instructions helped win an important game?

Most bankers and analysts are persuaded that the market is relatively indifferent to the interest-rate-risk posture of banking institutions, about which it is, in any case, painfully ignorant. In other words, the bank stock investor, say many, neither understands nor cares as much

Comment: Page 4 ➤

Fed Adopts Rules On Endorsement Of Bank Checks

By BARBARA A. REHM
Washington Bureau

WASHINGTON — The Federal Reserve Board on Monday adopted formal rules on how banks should endorse deposited checks. The measures take effect Sept. 1.

The guidelines are part of a larger effort to speed the processing of bounced checks, a longstanding operational problem for banks.

Separately, the Fed put out for public comment a proposal to ban so-called presentment fees. The checkwriter's bank sometimes charges such fees when the depositor's institution presents an item for collection before 2 p.m.

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→ Continued from Page 1

as he should how rate movements affect bank profits.

Not so, says First Manhattan Consulting Group. Periodically, the New York consulting firm performs a multiple regression analysis to determine what factors explain the variation in market-to-book ratios among banks. Its most recent exercise shows that two variables explain most of the 1987 differences.

Adjusting the Equity

One is, as might be expected, the current return on equity. But since banks substantially reduced their equity endowments last year in order to add disproportionately to loan-loss reserves, return on equity has become a somewhat deceptive number.

Because equity is artificially depressed, return on equity is higher than it otherwise would be, which is hardly a reason to bid up a bank's market value. Hence the marketplace must consider the level of loss reserves as well as the nominal ROE. Taken together, these two factors account for approximately 60% of the variation in 1987 market-to-book ratios.

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Editor: William E. Zimmerman
Managing Editor: Brian P. Sullivan
News Editor: Thomas J. Ferris
Associate Editors: Laura Gross, Sanford Rose, David O. Tyson

NEWS BUREAUS:
Washington: Chief, Robert Trigaux, 911 National Press Building, Washington, DC 20045; (202) 347-5529; Telecopier: (202) 628-6522.
Midwest: Chief, Richard Ringer, 53 W. Jackson Blvd., Suite 230, Chicago, Il 60604; (312) 663-6380; Telecopier: (312) 939-4925.
West Coast: Chief, Robert Luke, Suite 320, 510 W. Sixth St., Los Angeles, CA 90014; (213) 627-0953; Telecopier: (213) 627-8310.
San Francisco: Chief, Michael A. Robinson, 450 Sansome Street, Suite 1420, San Francisco, CA 94111; (415) 986-8705; Telecopier: (415) 398-4156.
Southwest: Chief, David LaGesse, Suite 1600, 8080 North Central Expressway, Dallas, TX 75206; (214) 891-8878; Telecopier: (214) 696-0050.
New England: Chief, Michael Weinstein, 210 South St., Boston, MA 02111; (617) 542-6848
London: Chief, John J. Duffy, American Banker, c/o Infopac S.A., 31-35 Beak St., London W1R 3LD England; (011) (441) 439-3066; Telecopier: (011) (441) 734-5153.

Feature Editions Editor: Patricia Stundza
Chief Statistician: L. Michael Cacace
Senior Editor, Copy Desk: Aileen L. Kyte
Art Director: Pamela Budz
Contributing Editor: Paul S. Nadler

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Telex: 421768 ABKR

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There are other significant explanatory variables. Among them obviously is the presence of LDC debt. The FMCG regression results indicate that the marketplace marks down bank stock prices by 20% of the book value of LDC debt, an appreciably lower discount than currently obtains in the debt market. (The debt market, less charitable than the stock market, believes that LDC loans are worth only about half of book.)

And then there is the discount for mismatched maturities. It clearly exists, points out Jon Moynihan, a First Manhattan managing vice president. That is, there is a statistically significant (t value greater than three) inverse relationship between mismatching behavior and bank stock price performance.

Other things being equal, banks that mismatch maturities have lower market-to-book ratios than those that are balanced. And the greater the mismatch, the bigger the hit to the stock price.

Measuring Mismatch

Now that finding may strain the credulity of some observers. They may allude to the much-publicized difficulty in measuring the mismatch position of banks, especially since reported balance-sheet maturity gaps are often offset by unreported off-balance-sheet activities — e.g., the use of derivatives like swaps, options, and futures.

They may also point out that many banks make substantial profits from mismatched maturities and since the market, as noted, lays considerable stress on return on equity, it is counterintuitive to suggest that all mismatching adversely affects the stock price.

FMCG agrees that it is difficult to measure the true mismatch position of banks that make abundant use of derivatives. But this use is largely confined to the top 20 banking companies. FMCG's findings on the connection between interest-rate risk and stock prices relate essentially to about 180 of the top 200 holding companies — those that are relatively unfamiliar with derivatives and whose mismatch position can therefore be approximated from an analysis of data from published call reports.

The consulting firm estimates the mismatch position of banks from such balance-sheet data, adjusted judiciously to reflect the appropriate duration of such items as demand deposits, and then compares the income or loss generated by this position with what would have been earned if the bank had been fully matched. This yields a measure of mismatch profits per dollar of equity, which is then regressed against the bank's market-to-book multiple.

Leaving aside the income effects, mismatching per se has, as noted, an adverse impact on stock price performance, although, in theory, the investor should reward those institutions, if there are any, whose mismatches are confined to markets where there is a liquidity premium (see this column, Feb. 3, 1988).

Opposing Vectors

However, the income effects are also important. Assuming relative stability in rates, the mere fact that the yield curve slopes upward means that banks whose liabilities are shorter than their assets will earn extra returns, while those whose liabilities are longer than their assets will sustain losses. And the stock market is indeed sensitive to profits.

Thus there are two conflicting vectors. On the one hand, the market apparently penalizes those who bet on rates. On the other hand, the market rewards high returns on equity. So, given the state of the yield curve, it may be thought that banks which are liability sensitive and in recent years have supplemented their ROEs with ample mismatch income would suffer comparatively little if any penalty to their stock price. By contrast, those that are asset sensitive and are therefore losing money should face an aggravated penalty.

Better to Lose Money

But such is not in fact the case. Although banks were penalized for mismatching their maturities in 1987, those that were asset sensitive were not hurt as severely as those that were liability sensitive, despite the fact that the former were losing money while the latter were enhancing their returns.

An asset-sensitive bank with a mismatch loss equal to three percentage points of pretax ROE should, according to the capital-asset pricing model, surrender as much as 15% of its stock valuation. In point of fact, according to these regression results, it suffered only a 1% penalty.

Now consider a liability-sensitive bank that augmented its 1987 pretax ROE by some three percentage points. Such a fillip to ROE, if achieved by methods other than rate betting, should, of course, translate into around a 15% gain in the stock price. But this institution actually experienced a 1987 decline in its stock valuation, and the decline was greater percentagewise than that suffered by its money-losing, asset-sensitive counterpart.

The marketplace is not only serving notice on banks that it does not value earnings realized from interest-rate betting. It is also signaling — at least it was last year — that long funding is less costly than short funding, regardless of the immediate income effects.

Expecting Inflation

Why is this so? The answer, suggests Mr. Moynihan, may reside in the fact that the bank investor is merely following the yield curve. Since the curve is upward sloping, the average investor expects rising interest rates.

He therefore assigns a relatively low discount rate to the earnings of a bank that is asset sensitive and thus positioned to benefit from the expected increase in rates. By the same token, he assigns a relatively high discount factor to the earnings of a bank that is liability sensitive and hence vulnerable to future rate increases.

In other words, the same economic conditions that give rise to the upward sloping yield curve — namely, an expectation of higher inflation — also help account for the discriminatory treatment of liability-sensitive mismatchers. These banks may think they are serving their shareholders by short funding themselves in order to make good current profits.

But the market, which is notoriously oriented to the future, votes otherwise. Based on the information provided by the yield curve, the market forecasts a disappearance of this type of mismatch profit and so exhibits a relative preference for asset-sensitive rather than liability-sensitive institutions.

To repeat — perhaps ad nauseam — all mismatches are bad, at least according to this FMCG analysis. But some are worse than others, regardless of their effect on current income. Mismatches that are based on an implicit forecast of interest rates which contravenes the consensus of the marketplace, as expressed in the prevailing yield curve, will result in heavier stock price losses than those made pursuant to a rate forecast with which the marketplace finds itself in agreement. ■

REQUIRED READING

Regulatory Principles for a Globalized Market

The following is an excerpt from remarks made by David S. Ruder, chairman of the Securities and Exchange Commission, to Keidanren, a leading Japanese economic association, in Tokyo on Feb. 18. The views expressed are those of Mr. Ruder and do not necessarily reflect those of the SEC.

□

I BELIEVE THAT the following regulatory principles should be considered by the markets throughout the world as they seek to adapt to internationalization: 1. Sound standards for disclosure, including mutually agreeable auditing and accounting standards;

2. Promotion of market fairness, including prohibitions against insider trading, market manipulation, and misrepresentations to the marketplace;

3. The widespread availability of quotation and price information;

4. Efficient and compatible national and international clearance and settlement systems;

5. Broker-dealer registration qualifications and conduct requirements designed to promote integrity and honesty in the profession;

6. Improvement of capital adequacy standards in order to provide greater stability and liquidity for national and international markets, and

7. Establishment of international surveillance and enforcement agreements. ■

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US Banks Fight for Share of Global Finance Market

→ Continued from Page 1

squeezing significantly more revenue out of their global networks.

"M&A is a terribly attractive product for a commercial bank," said Nicholas G. Walker, vice president for corporate finance at Bank of America International Ltd. "First, it is high profile. You're dealing with the chief executive when the rest of the bank is talking to the assistant treasurer. Second, if limited to an advisory role, it can produce risk-free fee income that is out of all proportion to the time put in."

Bankers say the time is right for a big push into international mergers and acquisitions. Despite the stock market crash, the wave of European acquisitions of U.S. companies spurred by the weak dollar has yet to crest. If anything, weak stock prices may enable cash-rich Europeans to buy even more.

Britain has been at the forefront of the spending spree in the United States. In 1987, U.K. businesses spent $29.2 billion to acquire 314 American companies, more than double the 1986 amount. A brief lull followed the market crash, but deals picked up again in January when Britain's BAT Industries PLC launched a $4.2 billion bid for Farmers Group Inc., a Los Angeles-based insurer.

Plans for a single European market in goods and services by 1992 are prompting corporate restructurings. In Britain the value of management buyouts totaled more than $5 billion in 1987, triple the 1986 total. Bankers say that with the vast number of small private companies that will have to be merged, acquired, or restructured before 1992, the pace of M&A activity on this side of the Atlantic is likely to heat up even more.

But while the market for international mergers and acquisitions is offering rich pickings, bankers say they are not necessarily easy pickings. Local merchant banks, particularly in Britain, have had a virtual stranglehold on domestic merger and acquisition business. Such ties are not easy to break, they say.

In a five-part series, the *American Banker* looks at banks' progress in investment banking. A report on private placements appeared on Monday, and the series continues tomorrow with a review of interest rate swaps. Once considered esoteric, swaps have become a necessary product for most financial institutions.

mergers and acquisitions. It recently financed the unsuccessful bid for Dee Corp., Britain's third largest supermarket chain, by Barker & Dobson Group PLC. The bank has played a part in bids ranging from Elders IXL's unsuccessful attempt to take over Allied-Lyons in 1985 to last year's successful bid by WPP Group PLC for J. Walter Thompson Inc., the advertising concern.

"We have a reputation for being relatively sophisticated lenders and for having imagination in our approach toward companies," said Colin Scotland, executive director of Citicorp's investment bank in London.

Citicorp has 17 merger and acquisition professionals in London and M&A units in Amsterdam, Frankfurt, Geneva, Madrid, Milan, and Paris. Although it is the world's top international bank, most of Citicorp's European M&A revenues stem from domestic European work rather than from trans-Atlantic deals with U.S. companies.

"In trans-Atlantic deals our hopes are higher than our achievement thus far," Mr. Scotland said. "In the U.K. and in Europe it's not hopes, it's reality. We're beginning to become a significant force."

In contrast, the international merger and acquisition efforts at Chase Manhattan Bank and Morgan Guaranty Trust Co. are focused on cross-border work — mostly Europeans seeking to buy or sell businesses in the United States. Morgan recently represented F. Hoffmann-La Roche & Co. of Switzerland in its unsuccessful bid for Sterling Drug Inc.

Chase recently represented Sanofi, a French drug company, in its unsuccessful attempt to acquire A.H. Robins Co. Last year, it represented Robert Maxwell's British Printing & Communications Corp. in an acquisition of Webb Printing Products in Minneapolis.

"If a business has some international appeal, a way of tapping the worldwide market is to use an institution like Chase, because we can, via our network, [find] buyers from all over the world," said Christopher Clegg, managing director of Chase Investment Bank Ltd. in London.

British Companies' U.S. Acquisitions

Top deals in 1987

Acquirer	Acquisition	Price ($ Mil.)
1. British Petroleum Co.	Standard Oil Co.	$7,560
2. Hanson Trust PLC	Kidde Inc.	1,700
3. Imperial Chemical Industries PLC	Stauffer Chemical Co.	1,690
4. Consolidated Gold Fields PLC	Newmont Mining Corp.	1,550
5. Blue Arrow PLC	Manpower Inc.	1,300
6. Grand Metropolitan PLC	Heublein Inc.	1,200
7. National Westminster Bank PLC	First Jersey National Corp.	820
8. Hawley Group PLC	ADT Inc.	715
9. Ferranti Ltd.	International Signal & Control	695
10. Thorn EMI PLC	Rent-a-Center Inc.	594
11. Pilkington PLC	Visioncare	574
12. WPP Group PLC	JWT Group Inc.	566
13. Guinness & Co.	Schenley Industries Inc.	480
14. Valor Ltd.	Yale & NuTone	460
15. Dixons Ltd.	Cyclops Industries Inc.	384
16. Smiths Industries PLC	Lear Siegler Diversified Holdings	350
17. TI Group PLC	John Crane-Houdaille Inc.	310
18. J. Sainsbury PLC	Shaw's Supermarkets Inc.	261
19. General Electric Co.	Gilbarco	250
20. Consolidated Gold Fields PLC	American Aggregates Corp.	242

Source: J.P. Mervis & Co.

Banks face the question of whether handling a hostile bid against a corporate client constitutes a conflict of interest.

"The challenge for an American bank doing European deals is to get yourself hired," said Colin J.G. Keer, managing director at Bankers Trust Co. in London. "It's that simple."

The banks say, however, that they have advantages over a merchant bank or an international investment bank. The large banks, for example, have had a physical presence in overseas money centers for generations. They have huge lending capacities and thus not only propose deals but also bankroll them.

American bankers say they take a more aggressive approach to dealmaking than their European counterparts. That sometimes means lending on the basis of a company's future cash flow and, more often than not, taking an actual equity stake in a restructured company.

In order to close the ASDA-MFI deal, for example, Chemical had to come up with an additional 50 million-pound, two-and-a-half-year, interest-free loan. In exchange for the loan the bank obtained a 5% interest in MFI.

"We have a far greater willingness to actually look at the underlying value of a business than certain other banks," said Chemical's Mr. Jackson. "Traditionally, certainly more so than the U.K. banks."

Among other U.S. banks, Citibank has forged a reputation in Britain as one of the most aggressive international banks in structuring and financing

'One-Stop Shopping' at Chase

Mr. Clegg, who was recruited from Oppenheimer & Co. to set up Chase's London M&A department in 1986, said the bank offers a "one-stop shopping" service to clients wishing to sell or buy a business in another country.

For example, for a U.S. client seeking to buy a Spanish company, Chase initially might take a "search and approach" assignment. That would then be carried through to the offer, the negotiation of the terms, the signing of the letter of intent, and finally to the signing of the contract. The bank could then put together a financing package, which might include a bridge loan, a Eurobond, or an equity placement in London.

The concept of one-stop shopping is not universally admired, however. Large companies tend to use different advisers for different aspects of a transaction, bankers say. And some banks decline to put their balance sheet at risk in M&A transactions overseas.

Bank of America, for example, takes only pure advisory roles in mergers and acquisitions in Europe. It concentrates largely on Spain, where it has corporate banking offices in Barcelona, Bilbao, Madrid, and Valencia and it specializes in arranging the sale of midsize Spanish companies to major international investors. It arranged five deals in Spain last year, more than any other foreign bank.

The troubling side of the banks' drive into M&A, both domestically and internationally, is that hostile bids and traditional bank relationships often run at cross purposes. Banks are increasingly faced with the question of whether a banking relationship with a corporate client raises a conflict of interest in handling a hostile bid against that client.

"It's the most delicate subject that Citicorp has to address in terms of its corporate client base at the moment," said Mr. Scotland of Citicorp. In Britain, Citicorp has gotten into scrapes with Dee Corp. and Allied-Lyons, both of which claimed the bank abused its relationship with them in financing hostile bids. Citicorp said neither relationship was strong enough to prevent it from taking an independent role.

"The problem is that, in the broadest possible definition of the word, Citicorp has relationships with almost every major company in the world," said Mr. Scotland.

A major advantage of M&A for commercial banks, however, is that it provides a good basis for selling other products and services. Bankers said M&A business can easily generate foreign exchange business, international debt and equity business, and even private banking transactions.

Mr. Walker of Bank of America noted, for example, that the bank recently acted as adviser on the sale of a midsize Dutch company to a French buyer. "We did the advisory role, we lent the money to finance the purchase, we did a foreign exchange contract taking French francs into Dutch guilders, and, finally having transferred the money to the seller, we took it back into Bank of America and put it on deposit for him in our private bank."

Such deals do not happen every day, and in fact tend to be rare, given the increasing sophistication of the M&A market in Europe. When they do happen, however, it tends to make up for all the deals that go awry.

"When you can totally control a transaction like that," Mr. Walker said, "it's like pulling the handle on a slot machine and seeing the money just come gushing out," he said. ■

Dear Reader, How Are We Doing?

The *American Banker* wants to make sure our investment banking series meets your information needs. So would you spend a moment to give us some feedback? Please clip out this questionnaire and return to: William Zimmerman, Editor, American Banker, One State Street Plaza, New York, N.Y. 10004 (212) 943-5712.

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